Accepted Manuscript

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PII: S0304-405X(17)30150-2
DOI: 10.1016/j.jfineco.2017.07.003
Reference: FINEC 2796


Received date: 16 October 2014
Revised date: 25 July 2016
Accepted date: 5 August 2016

Please cite this article as: Brent Glover, Oliver Levine, Idiosyncratic risk and the manager, Journal of Financial Economics (2017), doi: 10.1016/j.jfineco.2017.07.003

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Idiosyncratic risk and the manager

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June 2017

ABSTRACT
We develop a model to characterize and quantify the effects of stock, option, and fixed compensation on a manager’s risk-taking incentive and investment choice. We find the average chief executive officer’s (CEO) compensation contract incentivizes overinvestment by 1.3 percentage points per year, with significant variation across firms and over time. We estimate a value of CEO effort implied by compensation contracts and find it to be strongly related to firm intangibility. Finally, we assess the effects on investment of FAS 123R and a hypothetical ban on option grants and find heterogeneous responses that depend on firm volatility and the prior structure of compensation.

JEL classification: G31, G32
Keywords: Corporate investment; Executive compensation; Managerial incentives; Agency conflicts

\textsuperscript{*}We thank an anonymous referee, Toni Whited (the editor), Jonathan Berk, Philip Bond, Briana Chang, Diane Denis, Theo Dimopoulos, Rüdiger Fahlenbrach, João Gomes, Rick Green, Robert Kieschnick, Dmitry Livdan, Gregor Matvos, Erwan Morellec, Boris Nikolov, Marcus Opp, Berardino Palazzo, Josh Rauh, Alessio Saretto, Norman Schürhoff, Martin Szydlowski, Wei Wei, Jeff Zwiebel, and seminar participants at Carnegie Mellon University, Stanford Graduate School of Business, UCLA Anderson School of Management, University of Lausanne and Swiss Federal Institute of Technology in Lausanne (EPFL), University of Pittsburgh, University of Texas at Dallas, University of Wisconsin–Madison, University of Texas at Austin, the American Finance Association meetings, the University of British Columbia Winter Finance Conference, the Society for Financial Studies (SFS) Cavalcade, the Society for Economic Dynamics Conference, the University of Washington, Summer Finance Conference, and the Northern Finance Association Conference for helpful comments. This research was performed using the computing resources and assistance of the University of Wisconsin–Madison Center For High Throughput Computing (CHTC) in the Department of Computer Sciences. The CHTC is supported by the University of Wisconsin–Madison and the Wisconsin Alumni Research Foundation and is an active member of the Open Science Grid, which is supported by the National Science Foundation and the US Department of Energy Office of Science.

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